THE ECONOMY AT MIDYEAR—PROBLEMS AND PROSPECTS

REMARKS BY

John J. Balles

PRESIDENT
FEDERAL RESERVE BANK
OF SAN FRANCISCO

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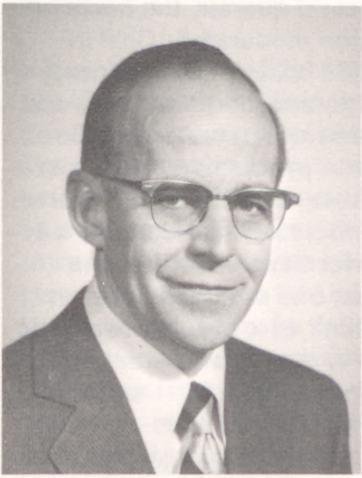

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It is a pleasure to be with you here today in the capital city of the intermountain West to discuss some of the major problems facing this region and the nation. In my remarks today, I would like to concentrate on the immediate problem of controlling an inflationary boom without at the same time bringing on a recession. My report thus begins with a look at the developing contours of the late-1973 economy.

The National Business Situation

The dimensions of the nationwide boom can be briefly stated. The first-quarter gain in GNP was one of the largest on record—$43 billion, or a 15-percent annual rate of increase. After allowance for price increases, the gain was still 8 percent, exceeding the strong 1972 gain and almost double the rate which economists consider sustainable over the long-run.

Then, in the second quarter, the hectic pace of expansion moderated: GNP increased about $29 billion, for a 9½-percent annual rate of increase in dollar terms and only a 2½-percent rate in real terms. Because of statistical problems, some experts contend that those second-quarter figures considerably understate the economy's actual growth performance. We'll let the experts fight that one out by themselves. Meanwhile, I think we can safely conclude that the economy decelerated somewhat during the spring months, but that the slowdown can be attributed mostly to the fact that the reserves of usable industrial capacity and experienced manpower were stretched dangerously thin by mid-year.

Because of the intense capital-goods boom, industry has found it impossible to work off its order backlogs, which for durable goods are now 29 percent above the year-ago level. As for the unemployment rate, it did not fall below 5 percent until June; but for married men, the rate had already dropped below 2½ percent, reflecting the severe shortage of experienced workers.

All these pressures have resulted in an unprecedented price upsurge. The GNP price index rose at an annual rate of about 6½ percent during the first half of the year —more than twice the 1972 pace—and consumer prices rose at about an 8-percent rate during the same period, largely because of the phenomenal jump in food prices. Equally worrisome, however, has been the rise in wholesale industrial-commodity prices; these increased at a 15-percent annual rate from the inception of Phase III in January to the advent of Freeze II in June. Admittedly, wholesale prices dropped sharply in July, but that was a freeze-related statistical quirk which will almost certainly be reversed in coming months.

Where We Are Heading

The question thus arises: can we slow down the boom to a more sustainable and less inflationary pace without at the same time pushing the economy into recession? There is an undeniable risk that we cannot, since the business-cycle history of the past generation suggests that it is difficult for the U.S. economy to make the transition from inflationary boom to noninflationary growth without an intervening recession. In my opinion, however, a recession is not inevitable, and our chances of avoiding one will be greatly enhanced if we pursue restrictive anti-cyclical policies today to bring the boom under control.

Having made that crucial assumption about policy, my economic research staff's forecast shows GNP rising from $1,155 billion in 1972 to about $1,285 billion in 1973 and (very tentatively) to about $1,380 billion in 1974. More importantly, the forecast indicates that the economy will decelerate in real as well as in money terms, with the real rate of growth falling from a peak 5½-percent rate in the first half of 1973 to a 3½-percent rate in the current half-year, and then to about 3 percent in 1974. With inflationary pressures subsiding, the upsurge in the GNP price index should taper off, following a 6½-percent annual rate of increase in the first half of this year. The research staff projects GNP price increases of about 5 percent in the second half of 1973 and 4½-percent in 1974.

Several different sectors will be responsible for the relative slowdown in activity. Residential construction, the main support of the early stages of the boom, is likely to show an actual decline, both in dollar terms and in the number of housing starts. The number of starts could decline from 2.4 million in 1972 to 2.1 million in 1973, and 1.8 million in 1974. The decline can be blamed upon rising construction and mortgage costs, as well as a reaction from the earlier overbuilding by some contractors. Also, with the housing sector declining, purchases of furniture and appliances are likely to moderate from their recent heavy pace.

Auto spending similarly should decelerate, partly because of the unsustainable sales pace of recent quarters and partly because of the heavy burden of debt now overhanging consumers. By year-end, considerably more than one-fourth of all the 100 million cars on the road will be less than three years old. As a result, the replacement rate should decline and contribute to some weakening of sales over the next year or so.

Other sectors, although decelerating, should register respectable increases in dollar terms—for example, government spending, consumer spending except for durables, and in particular, business fixed-investment spending. Actual spending for plant and equipment has recently trailed spending plans and appropriations, because of bottlenecks and delays of various types, and order backlogs for capital goods consequently have expanded. Because of this catch-up factor, capital-goods spending will probably continue high even if some easing of sales occurs at the retail level.

The nation's farmers, who despite sharply rising costs are still flush with cash, are likely to increase their spending substantially, both for consumer goods and capital equipment. In addition, export demand should remain very high, because of both the continued food shortages overseas and the bargain-basement prices for American goods available as a result of the several devaluations of the dollar.

The Outlook—Intermountain States

The economy of the intermountain states should reflect all of these national developments, and in particular the two factors just cited—the farm boom and the related export boom. Both Idaho and Utah can expect whopping increases in gross farm income this year, and despite substantial increases in production expenses, that means very strong gains in net income as well.

In Idaho, cash farm receipts could rise 30 percent or more, to almost $1 billion for the year. This boom is being sparked by higher receipts from each of the state's major products—beef cattle, potatoes and wheat. Utah's farmers and ranchers also should do very well, with a gain of perhaps 20 percent in total receipts to almost $300 million for the year. In this state, the boom reflects higher proceeds from the sale of both crops and livestock, despite a moderate decline in the production of red meat.

In construction, we are likely to encounter a mixed bag of statistics, just as in the nation. To date this year, residential permit activity in Idaho and Utah has lagged about 11 percent and 8 percent, respectively, behind the very strong 1972 pace. For 1973 as a whole, the decline should be even greater, in view of the present tightening of mortgage markets and the inexorable rise of construction costs. (Because of spiraling construction costs, however, we are likely to see a continuation of the strong market for mobile homes, which now represent about the only type of housing that can be found for below $20,000.) Highway and public-works spending may be maintained at about the year-ago pace, but the upsurge in factory and commercial construction should continue for quite a while yet.

Demand for the products of the metals industries should begin to slacken somewhat as the nationwide boom begins to cool, but that development appears to be still some months away. In the meantime, Utah's copper and steel industries should continue to operate at capacity, as they have been doing lately, and production of other metals should hold at or near recent levels.

As the boom begins to subside, we should see some moderation in the heavy demand for workers in this region. Idaho and Utah (especially the latter) have both outpaced the national gain of 6 percent in nonfarm employment during the boom of the past year and a half, and this faster-than-national pace has been evident in almost every sector of the regional economy. At the same time, the flood of jobseekers has been relatively larger in this area than in other parts of the nation, so that the unemployment rate has fallen at a slower pace than it has elsewhere—specifically, from 5.7 to 5.1 percent for Idaho, and from 6.4 to 5.5 percent for Utah. Most of the improvement in the jobless situation came about just in the last several quarters, however, and the prospects for a further decline in the near-term future appear rather good because of the expectation of a continued high level of farm and factory activity.

In terms of personal income—the broadest measure of regional activity—the Idaho economy should grow from some $2.7 billion last year to $3.0 billion in 1973, while the Utah economy should grow from $4.2

billion to $4.6 billion over the same time-span. Next year, with some deceleration in the regional as well as in the national economy, we may see Idaho's income increasing to almost $3.2 billion and Utah's total rising to about $5.0 billion.

At the present stage, however, deceleration is not our greatest worry, but rather the continuing over-rapid pace of expansion. This situation is amply reflected in your own banking statistics. In Idaho, in the first half of this year, member banks posted almost a 20-percent increase in total loans (at an annual rate) while reducing investment portfolios at a 14-percent rate; in Utah, the comparable figures were a 10-percent gain in loans and a 9-percent reduction in investments. This suggests that a slowdown in credit demands, especially for business loans, should benefit your own liquidity positions as well as the needs of the national economy.

The Policy Problem

At the present juncture, then, the nation's policymakers have their work cut out for them. The most critical task, of course, is to bring the economy back to a sustainable growth path and to reduce the unacceptable rate of inflation which now besets us.

Phase IV controls have a role to play here, by limiting wage and price increases until broader policy restraints can take hold. As that statement suggests, however, controls are only a stopgap; indeed, as recent news stories have indicated, they sometimes create their own market distortions to aggravate those already generated by the inflationary boom. Controls, in a word, cannot take the place of a coordinated program of monetary and fiscal measures.

The Federal budget will be less expansionary over the coming year as it moves towards balance. It would have been much better if this had been done earlier. Indeed, in the past year the Federal budget picture has been highly perverse, with fiscal 1973's $14-billion deficit stimulating rather than curbing the inflationary economy, and in the process, heaping demands on credit markets and pushing up the level of interest rates.

The situation admittedly could have been worse, because the official budget figures last January indicated a $25-billion deficit for the fiscal year. Even so, the relative improvement since then cannot be attributed to any conscious policy decision, but rather to the impact of rising prices, incomes and profits on tax collections. The Administration and Congress deserve credit for holding expenditures below the $250-billion target, but they have been widely criticized for not having moved much faster in the direction of budgetary restraint—through tax increases, if necessary.

Certainly Congress is not lacking for suggestions for ways of using the Federal budget as a better weapon of counter-cyclical policy. Federal Reserve Chairman Arthur Burns advanced three specific proposals of this type in several Congressional appearances in recent weeks. One proposal, which could have ecological as well as economic benefits, would be a tax on autos based on horsepower. Another would be the enactment of a variable investment tax credit as a means of curbing business spending booms. In addition, Chairman Burns proposed a compulsory savings plan, that would force corporations in inflationary times to turn over a certain proportion of their profits to Federal Reserve escrow account, and that would then provide for a return flow of funds in less buoyant times.

All these measures, designed as they are to smooth the extremes of the business cycle, would have been extremely useful if they had been in effect this past year. In their absence, however, continued stress has had to be placed upon the weapons of monetary policy. In its initial attempts to counter the inflationary boom, the Federal Reserve tightened open-market policy early last winter, and thereby limited the supply of bank reserves in relation to swelling credit demands. These actions were supplemented in mid-May when the System turned its attention to the increasing commercial-bank reliance on money-market sources of funds, by imposing a supplementary 3-percent reserve requirement on large CD's and related instruments in excess of those held in the mid-May base period.

Then, around mid-year, the Federal Reserve moved up its heavier artillery, with an across-the-board increase in reserve requirements on member-bank demand deposits. By raising reserve requirements one-half percentage point—for example, from 17½ to 18 percent for the largest banks—the System required an addition of about $800 million to the reserves supporting the loan and deposit structure of the banking system.

The Federal Reserve also raised its discount rate for the sixth time this year, so that it now stands at 7 percent—a figure matched only during the tight-money period of 1920-21. This action reinforces open-market policy by discouraging the further borrowing of reserves. (Borrowings during the spring months were about three times the level of last fall and considerably above the 1969 peak.) Instead, the higher discount rate encourages banks to adopt a more cautious lending policy and thereby helps to reduce the further expansion of credit. Finally, the monetary authorities raised the ceiling on interest rates that banks and thrift institutions may pay on passbook savings and other consumer accounts, partly to provide consumers with a greater measure of equity in the present environment of rising interest rates, but more importantly, to minimize the risk of savings outflows and guard against the shrinkage of the supply of mortgage funds.

Throughout this period of tightening credit, the Federal Reserve has acted to forestall a repetition of a credit crunch of the 1966 or 1969-70 variety, when many borrowers suddenly found funds to be unavailable at any price. To keep funds available, the authorities have used such techniques as the raising of rate ceilings on consumer savings and the complete suspension of ceilings on large CD's. Consequently, the credit needs of the expanding economy have been met, although with credit rationing through interest rates becoming more stringent.

Summary and Conclusions

To sum up, this region and the nation are now involved in an inflationary boom which some observers believe could deteriorate into recession, as has happened so often in the past. With proper policy measures, however, I believe that we can slow down the boom, and experience nothing worse than a temporary period of subnormal growth as we move into 1974. Flexibility must be our watchword. This means that we must apply the pressure, both through fiscal and monetary means, until the overheated economy shows signs of easing, and must then move to a more moderate stance to support long-run growth.

Business fixed-investment spending should remain high next year as businessmen strive to add new capacity to meet the future needs of the national economy, but the pressure from that source should moderate over time as consumer buying slows and as housing spending actually declines. The regional economy will be affected by all of these conflicting factors, but also by one special factor—the heavy worldwide demand for the agricultural products of the Mountain States.

With the development of Phase IV controls and the gradual improvement in the nation's fiscal position, a balanced set of policy measures hopefully will be set in place to govern the 1974 economy. The Federal Reserve, having supported the recovery from the earlier recession, now stands ready to support an ongoing expansion in line with the long-term growth trend of the national economy. To do so, however, it needs the cooperation of all members of the banking community, in line with Chairman Burns' request that the rate of bank-credit extension be "appropriately disciplined." Similarly, it needs the support of all members of the general business community, who from their own self-interest should postpone marginal expansion projects until the time when the scramble for resources becomes less hectic. I am sure that all of you will see the wisdom of such a course.